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Date 2/25/97

Signature [redacted]

[redacted]
[redacted]
[redacted]
[redacted]
CP: E:EO:T:3

DEC 23 1996

Dear Sir or Madam:

We have considered your application for recognition of exemption under section 501(c)(3) of the Internal Revenue Code.

The information submitted indicates that you were formed on [redacted] under the laws of [redacted].

You are a membership organization. Your members are five unrelated nursing homes operating in the state of [redacted]. All of your current members have been recognized exempt under section 501(c)(3) and classified as publicly supported organizations under section 509(a)(2) or 170(b)(1)(A)(vi).

You were formed by the execution of a trust agreement. Your trust document provides that your stated purposes are as follows:

"to discharge the obligations of the Members pursuant to the [redacted] by providing Members' employees compensation benefits at levels equal to those required by the [redacted]..."

You were formed to provide workers' compensation benefits for the employees of your member nursing homes. You state that you provide risk management and serve as a risk sharing facility for your members to discharge their obligations under the [redacted]. You state that you provide members' employees workers compensation benefits at levels equal to those required under state law. You provide coverage for [redacted] employees of your member nursing homes.

You have received a permit from [redacted] to "operate as a group self-insurance fund" under state law. Your primary source of support is contributions from your member nursing homes. You received a total of \$ [redacted] in contributions from members for period beginning [redacted] and ending [redacted].

Section 501(c)(3) of the Internal Revenue Code provides for the exemption of organizations that are organized and operated exclusively for religious, charitable, or educational purposes, no part of the net earnings of which inures to the benefit of any shareholder or individuals.

Section 501(m)(1), as added by section 1012(a) of the Tax Reform Act of 1986, P.L. 99-514, October 22, 1986, provides that an organization described in section 501(c)(3) or (4) will be eligible for recognition of exemption under section 501(a) 'only if no substantial part of its activities consists of providing commercial-type insurance.' The statute provides no definition of this term, although section 501(m)(3) provides that certain enumerated activities by an exempt organization shall not be considered the provision of commercial-type insurance for purposes of section 501(m).

The legislative history, however, provides some guidance with respect to the definition of the term 'commercial-type insurance.' The House Report in discussing section 501(m) provides that commercial-type insurance generally is any insurance of a type provided by a commercial insurance company. H.R. Rep. No. 426, 99th Cong., 1st Sess. 665 (1985). The General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress, P.L. 99-514) states:

[C]ommercial-type insurance does not include arrangements that are not treated as insurance (ie., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance). For example, if a hospital that is exempt from tax under section 501(c)(3) establishes a trust to accumulate and hold funds for use in satisfying malpractice claims against the hospital, the arrangement does not constitute insurance and accordingly is not treated as providing commercial-type insurance. Id. at 585-86.

Section 513(a)(1) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to tax under section 511, any trade or business, the conduct of which is not substantially related, aside from the need of such organization for the income or funds or the use it makes of the profits derived, to the exercise or performance by such organization of its charitable, educational, or other purposes or functions constituting the basis of its exemption under section 501.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that in order for an organization to be exempt as an organization described in section 501(c)(3), it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(b)(1)(i) of the regulations provides that, in general, an organization is organized exclusively for one or more exempt purposes only if its articles of organization limit the purposes of such organization to one or more exempt purposes, and do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income) and is "substantially related," for purposes of section 513 of the Code, only where the causal relationship is a substantial one. In other words, the production of goods or the performance of services from which gross income is derived must contribute importantly to the accomplishment of the organization's exempt purposes.

In Better Business Bureau v. United States, 326 U.S. 279, 283 (1945) the U.S. Supreme Court stated in a case involving a claim for exemption on exclusively educational grounds:

In order to fall within the claimed exemption an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single noneducational purpose, if substantial in nature, will destroy an organization's exemption regardless of the number or importance of truly educational purposes.

You are not organized and operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code. By providing workers' compensation insurance for your member nursing homes under the circumstances described you are engaged in the provision of commercial type insurance under section 501(m) of the Code. Your insurance activities constitute a substantial nonexempt purpose and activity within the meaning of section 1.501(c)(3)-1(c)(1) of the regulations. Substantially all of your income will be derived from the contributions from member nursing homes for purposes of paying workers' compensation claims submitted by their employees. Therefore, a substantial part of your programs and activities will be devoted to providing commercial type insurance described in section 501(m) and conducting an unrelated trade or business within the meaning of section 513.

You are required to file federal income tax returns. Contributions to you are not deductible under section 170 of the Code.

You have a right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your principal officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your principal officers, that person will need to file proper power attorney and otherwise qualify under our Conference and Practice Procedures.

If you do not protest this proposed ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Internal Revenue Code provides, in part, that, "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the United States Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service".

If we do not hear from you within 30 days, this ruling will become final and copies of it will be forwarded to your key District Director. Thereafter, any questions about your federal income tax returns or the filing of tax returns should be addressed to that office.

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[REDACTED]
[REDACTED]

When submitting additional letters with respect to this case to the Internal Revenue Service, you will expedite their receipt by placing the following symbols on the envelope:

Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224
CP:E:EO:T:3,
Attention: [REDACTED] Room 6137.

Sincerely,

[REDACTED]
Edward K. Karcher
Chief, Exempt Organizations
Technical Branch 3

cc: [REDACTED]
[REDACTED]